Policy and Oversight

Financial and Performance Audit Directorate

Quality Control Review

Ernst and Young LLP
South Carolina Research Authority
Fiscal Year Ended June 30, 1995

Report Number PO 97-038

June 30, 1997

Office of the Inspector General
Department of Defense

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Acronyms

DCAA	Defense Contract Audit Agency
GAAS	Generally Accepted Auditing Standards
GAS	Government Auditing Standards
OMB	Office of Management and Budget
SCRA	South Carolina Research Authority

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

June 30, 1997

Ernst & Young LLP
1300 Huntington Building
925 Euclid Avenue
Cleveland Ohio, 44115

Director
Defense Contract Audit Agency
8725 John J. Kingman Road, Suite 2135
Fort Belvoir, Virginia 22060-6219

SUBJECT: Quality Control Review of Ernst & Young LLP
South Carolina Research Authority
Fiscal Year Ended June 30, 1995
Report No. PO97-038

Introduction

We are providing this report for your information and response. The firm of Ernst & Young LLP and the Defense Contract Audit Agency (DCAA) performed the coordinated single audit for the South Carolina Research Authority (SCRA), Columbia, South Carolina, a nonprofit organization engaged in developing and marketing a statewide system of research parks and research and development programs. The audit is required by the Office of Management and Budget (OMB) Circular A-133, "Audits of Institutions of Higher Education and Other Nonprofit Institutions." The SCRA did not prepare a Schedule of Federal Awards for the fiscal year ended June 30, 1995. The DCAA incurred cost audit reported total award expenditures of $20,532,031.

Ernst & Young LLP issued its audit report dated August 8, 1995, questioned no costs, and issued an unqualified opinion on the financial statements. Ernst & Young LLP issued positive and negative assurance statements on compliance with the general requirements pertaining to political activity, Davis-Bacon Act,

civil rights, and the Drug-Free Workplace Act. Positive Assurance states that, with respect to the items tested, the results of the auditors' procedures disclosed no material instances of noncompliance. Negative assurance states that, with respect to the items not tested, nothing came to the auditors' attention that caused them to believe that the institution has not complied in all material respects.

The DCAA incurred cost audit report, dated June 28, 1996, also questioned no costs. The DCAA issued positive and negative assurance statements on the general requirements pertaining to allowable costs and cost principles. The DCAA did not express an opinion on the specific requirements of types of services allowed or unallowed; eligibility; matching, level of effort, and/or earmarking requirements; special reporting requirements; and special tests and provisions, as required by Circular A-133. With the exception of subcontract costs that were qualified pending receipt of the assist audit reports, the DCAA issued an unqualified opinion on the direct and indirect costs applicable to the SCRA research and development program.

Quality Control Review Results

The OMB Circular A-133 audit did not meet the applicable guidance and regulatory requirements in the Circular, its related Compliance Supplement, Government Auditing Standards (GAS), Generally Accepted Auditing Standards (GAAS), and the provisions of the Federal award agreements. See Discussion of Findings.

Quality Control Review Objective

The objective of a quality control review is to ensure that the audit was conducted in accordance with applicable standards and meets the auditing requirements of OMB Circular A-133. As the Federal oversight agency for SCRA, we conducted a quality control review of the audit working papers. We focused our review on the following qualitative aspects of the audit: due professional care, planning, supervision, independence, quality control, internal controls, substantive testing, and general and specific compliance testing.

We reviewed the most recent peer review letter, dated November 13, 1995, by KPMG Peat Marwick LLP. KPMG Peat Marwick LLP found that Ernst & Young LLP met the objectives of the quality control review standards established by the American Institute of Certified Public Accountants and that the standards were being complied with during the fiscal year ended June 30, 1995. We continuously monitor the quality of the DCAA audit work.

Scope and Methodology

We used the 1991 edition of the Uniform Quality Control Guide for Single Audits (the Guide) that was approved by the President's Council on Integrity and Efficiency as guidance for performing the quality control review procedures. The Guide is organized by the general and field work audit standards and the required elements of a single audit. The Guide is further divided into the substantive work performed during the audit of the financial statements and the specific program compliance testing for major programs. In addition, we supplemented the Guide to include additional review of the Ernst & Young LLP internal control and compliance transaction testing. We did not review the working papers supporting the work done by the DCAA as part of the single audit of SCRA. We conducted our review in December 1996.

Ernst & Young LLP was engaged to perform the financial statement audit of SCRA in accordance with GAAS and to perform the audit of certain general requirements related to major Federal awards programs. The general requirements tested were political activity, Davis-Bacon Act, civil rights, and the Drug Free Workplace Act. The DCAA performed an incurred cost audit of SCRA that satisfies the general requirement covering allowable costs and cost principles as applicable to Research and Development. The DCAA applied audit procedures on the specific requirements covering allowable services; matching/level of effort; special reporting requirements, and the special tests and provisions. However, the DCAA did not express an opinion on the specific requirements, as required by the OMB Circular A-133.

Results of Prior Quality Control Reviews

We identified minor quality control review findings and recommendations at four of the six Ernst & Young LLP locations we visited from January 1, 1995, through December 31, 1996. The affected offices were notified, and no further action is necessary. DCAA reports and operations are reviewed by this office on an ongoing basis.

Background

The Inspector General Act of 1978, as amended in 1988 by Public Law 95-452, prescribes the duties and responsibilities of that office. In implementing the responsibilities, the Inspector General is required to "take appropriate steps to assure that any work performed by non-Federal auditors complies with the standards established by the Comptroller General."

The Single Audit Act of 1984 (Public Law 98-502) was intended to improve the financial management of state and local governments whose total annual expenditures are $100,000 or more with respect to Federal financial assistance programs; establish uniform requirements for audits of Federal financial assistance; promote efficient and effective use of audit resources; and ensure that Federal departments and agencies rely on and use the audit work done under the Act, to the maximum extent practicable.

The Single Audit Act Amendments of 1996, based on 12 years of experience under the 1984 Act, are intended to strengthen the usefulness of single audits. by increasing the audit threshold from $100,000 to $300,000 in Federal financial assistance before an audit is required under the Act; selecting programs to be audited on the basis of risk assessment rather the amount of dollars involved; and improving the contents and timeliness of single audits. The Amendments also bring nonprofit organizations, previously covered by similar requirements under the OMB Circular A-133, under the Single Audit Act provisions.

The OMB Circular A-133 establishes the Federal audit and reporting requirements for nonprofit and educational institutions whose Federal awards are or exceed $100,000. It provides that an audit made in accordance with the Circular shall be in lieu of any financial audit required under individual Federal awards. An agency must rely on the audit to the extent that it provides the information and assurances that an agency needs to implement its overall responsibilities. The coordinated audit approach provides for the independent public accountant, Federal auditor, and other non-Federal auditors to consider each other's work in determining the nature, timing, and extent of their respective audit procedures. The Circular also requires that the cognizant agency obtain or conduct quality control reviews of selected audits made by non-Federal auditors and provide the results, when appropriate, to other interested organizations. When the OMB has not assigned a cognizant agency, then the Federal agency that provides the predominant amount of direct funding to a recipient is designated as the oversight agency. The oversight agency is responsible for providing technical advise and counsel to institutions and independent auditors when requested by the recipient and may assume all or some of the responsibilities normally performed by the cognizant agency. The Circular is being revised to incorporate the changes in the Single Audit Act Amendments of 1996.

Discussion of Findings

Procurement of OMB Circular A-133 Audit. The SCRA did not have its OMB Circular A-133 audit conducted in accordance with the provisions of the Circular. Specifically, the audit by the independent public accountant was not

Circular. Specifically, the audit by the independent public accountant was not made in accordance with GAS. Attachment to OMB Circular A-133, paragraph 2.a., requires nonprofit institutions that receive $100,000 or more a year in Federal awards to have an audit conducted in accordance with the provisions of the Circular. The Circular also requires that the audit be made by an independent auditor in accordance with GAS. In a financial statement audit conducted in accordance with GAS, the auditor assumes additional responsibilities, beyond those assumed in an audit conducted in accordance with GAAS, to report on compliance with laws and regulations on the internal control structure.

While arranging for the OMB Circular A-133 audit is the responsibility of the recipient, the auditor should have recognized that reliance would be placed on the audit results by the Federal Government and all other levels of government that provide substantial funds to the recipient. Specifically, paragraphs 21 through 23 of SAS No. 74 describe the auditor's responsibility when he or she has been engaged to perform an audit in accordance with GAAS and becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. In such a situation, SAS No. 74 requires that the auditor communicate to management and the audit committee, or to others with equivalent authority or responsibility, that an audit in accordance with GAAS alone may not satisfy the relevant legal, regulatory, or contractual requirements. The auditor should consider how the client's actions in response to such communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements.

We found that the engagement letter and subsequent correspondence between Ernst & Young LLP and SCRA clearly indicate that Ernst & Young LLP was aware that SCRA was subject to an audit in accordance with GAS because SCRA received Federal awards. The engagement letter does not specifically state that Ernst & Young LLP agreed to follow specified GAS, guides, procedures, statues, rules, and regulations. However, Ernst & Young LLP was aware that SCRA was subject to an audit requirement not specifically encompassed in the terms of the engagement letter and did not communicate to management that an audit in accordance with GAAS alone would not satisfy the relevant legal, regulatory or contractual requirements. Because Ernst & Young LLP did not follow GAS, a report on compliance and internal controls based on an audit of the financial statement was not issued. A report on the internal controls is required whether or not reportable conditions are noted and to identify those reportable conditions that are significant enough to be material weaknesses. The report on compliance covers other than illegal acts and encompasses Federal, state and local laws and regulations that, if violated, could materially affect the basic financial statements. Failure to report on compliance and internal controls at the financial statement level does not

provide the Federal awarding agencies the needed assurances concerning the recipient's financial statements. This assurance is necessary to proceed with such actions as negotiating indirect cost rates.

Schedule of Federal Awards. A Schedule of Federal awards was not prepared by SCRA, and an opinion on the Schedule of Federal Awards was not rendered by Ernst & Young LLP. For the auditor to determine what major programs are to be tested for compliance, OMB Circular A-133, Attachment, Paragraph 15.c.(1), requires that the recipient identify, in accounts, all Federal funds received and expended and the programs under which they were received. The Schedule should include funds received directly from Federal agencies, through other state and local governments or other recipients. SCRA is required to prepare a Schedule of Federal Awards to identify major programs to ensure that the auditors perform appropriate compliance testing for major programs. Failure to prepare the Schedule does not ensure that major programs are identified so that appropriate compliance testing can be performed. Therefore, without the Schedule of Federal Awards and an opinion on that Schedule, we have no assurance that all major programs were identified and subjected to the necessary tests and procedures to ensure that the compliance requirements that could have a direct and material effect on the major Federal programs were met in accordance with OMB Circular A-133, paragraph 15(c)(1).

Compliance Requirements. The DCAA report on incurred costs addressed compliance with the following specific requirements: allowable services, matching/level of effort, special reporting requirements, and special tests and provisions. However, in it's report the DCAA did not express an opinion on the compliance with these specific requirements, but issued a statement of positive and negative assurance. The OMB Circular A-133, paragraph 15(c)(3), requires an auditor to express an opinion on the report covering the specific requirements. In determining compliance with the laws and regulations, the auditor is required to select and test a sufficient number of transactions to support an opinion on compliance with specific requirements related to each major program. This report should cover types of services allowed or unallowed; eligibility; matching, level of effort, and/or earmarking requirements; special reporting requirements; and special tests and provisions. Failure to express an opinion on compliance with specific requirements does not provide the Federal awarding agencies the needed assurances concerning the recipient's financial statements, and the Schedule of Federal Awards.

The Compliance Supplement identifies general requirements for which the auditor should test compliance in all OMB Circular A-133 audits whether or not the recipient has major programs. The auditor is not expected to express an opinion on a recipient's compliance with the general requirements.

Recommendation for Corrective Action

We recommend that South Carolina Research Authority:

1. Request Ernst & Young LLP to issue the required reports on internal controls and compliance as part of the financial statement audits under Office of Management and Budget Circular A-133 at no additional cost to the Government.

2. Prepare a Schedule of Federal Awards, have the schedule audited in accordance with Office of Management and Budget Circular A-133, and submit the report on the Schedule of Federal Awards that includes an auditor's opinion to our office.

3 Request the Defense Contract Audit Agency to issue an opinion on the South Carolina Research Authority report on specific requirements.

Discussion of Results

During our quality control review, we reviewed and took no exception to the working papers supporting the following reports and schedules.

Report of Independent Auditors. The auditor is required to obtain reasonable assurance about whether the financial statements are free of material misstatement. We reviewed the audit program and the testing of the evidential matter to determine whether testing was sufficient based on assessment of control risk to warrant the conclusion reached and whether the working papers support the conclusion. As noted above, because Ernst & Young LLP did not perform its audit in accordance with GAS, the required GAS statements were not included in its report.

Independent Auditors' Report on Compliance with General Requirements Applicable to Federal Financial Assistance Programs. The auditor is required to determine whether the recipient has complied with laws and regulations that may have a direct and material effect on any of its major Federal programs. General requirements are those that could have a material effect on the recipient's financial statements, including those prepared for Federal programs. The auditor's procedures were limited to those prescribed in the OMB "Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions." We reviewed the audit program for the appropriate procedures, compared the audit program steps to those in the Compliance Supplement to make sure that all areas were audited, reviewed the working paper documentation and its support, reviewed the compliance tests performed, and reevaluated selected compliance items.

Although the DCAA performed various procedures related to certain specific compliance requirements and the internal control structure over compliance with those specific requirements, we did not review the DCAA audit working papers. We notified the DCAA in December 1996 that its reports did not meet the reporting requirements of OMB Circular A-133. The DCAA has issuance guidance to its field offices that will ensure future OMB Circular A-133 meet the Circular reporting requirements and provide the necessary assurances that appropriate tests and procedures have been performed. Also, as part of our quality control review, when the DCAA participates in a coordinated audit, we will review the DCAA working papers.

Comments

Because this report contains findings and recommendations, written comments are required within 60 days of the date of this report. See enclosure for report distribution. We appreciate the courtesies extended during the review. If you have questions on this report, please contact Mr. Donald Steele, Project Manager, at (703) 604-8705.

Russell A. Rau
Assistant Inspector General
Policy and Oversight

Enclosure

South Carolina Research Authority
Fiscal Year Ended June 30, 1995

Distribution List

Mr. Anthony Callander, Partner
Ernst & Young LLP
Two Insignia Financial Plaza
Suite 800
Greenville, SC 29603

Board of Trustees
South Carolina Research Authority
P.O. Box 12025
Columbia, SC 29211

Director, Defense Procurement
Office of the Under Secretary of Defense
3060 Defense Pentagon
Washington, DC 20301-3060

Director, Defense Research & Engineering
Office of the Under Secretary of Defense
3030 Defense Pentagon
Washington, DC 20301-3030

Commander
Defense Contract Management Command
8725 John J. Kingman Road, Suite 4539
Fort Belvoir, Virginia 22060-3060

Enclosure

Evaluation Team Members

This report was prepared by the Financial and Performance Audit Directorate, Office of the Assistant Inspector General for Policy and Oversight, DoD.

Barbara E. Smolenyak
Donald D. Steele
Sunil R. Kadam
Andrew Katsaros
Nancy C. Cipolla